## A. CHURCHES AND RELIGIOUS ORGANIZATIONS

1. Introduction

Highly publicized accounts of alleged misconduct by televangelists have resulted in increased scrutiny of the Service's treatment of churches and religious organizations. The Service continues to be challenged in this area with the difficult task of balancing its need to enforce the tax laws with the need to respect the Constitutional rights of religious organizations.

This topic provides an overview of the developments during the past year in litigation and administration that affect churches and religious organizations.

2. Litigation Update

In 1988, Abortion Rights Mobilization v. Baker continued its odyssey through the court system. On June 20, 1988, the Supreme Court issued an opinion that neither addressed the underlying dispute over the tax exempt status of the Catholic Church nor the merit of the issue of Abortion Rights Mobilization's (ARM) standing to sue. The Court's holding may, however, have significant impact on civil procedure law.

As discussed in last year's text, the Supreme Court had agreed on December 7, 1987, to review a decision by the Second Circuit which affirmed a District Court's contempt order against the United States Catholic Conference (USCC) and the National Conference of Catholic Bishops (NCCB), as non-party witnesses, for refusing to comply with subpoenas. The Second Circuit in reaching its ruling had rejected the Conference's argument that ARM had no standing to bring the underlying suit against the Internal Revenue Service and, therefore, the District Court lacked subject matter jurisdiction to issue subpoenas in support of ARM's case. The Second Circuit concluded that the District Court had "colorable jurisdiction" to hear the case.

The Supreme Court, in an opinion written by Judge Kennedy for an eight member majority, reversed the Court of Appeals decision. The Court held that the power to issue and enforce the subpoenas against USCC and NCCB is not more extensive than the Court's jurisdiction over the subject matter of the case. Therefore, if the District Court does not have subject matter jurisdiction over the underlying action because ARM lacks standing and the subpoenas were not issued

in aid of determining that jurisdiction, then the subpoenas are void and civil contempt orders based on a refusal to honor the subpoenas must be reversed. Based on this analysis, the case was remanded to the Court of Appeals for a determination of whether or not the District Court had subject matter jurisdiction of the underlying action.

Although the Supreme Court did not decide whether or not ARM had standing to sue, Justice Kennedy asserts, in dictum, that the nonwaivable defense of subject matter jurisdiction rests on the principle "that courts have finite bounds of authority, some of constitutional origin, which exist to protect citizens from the very wrong asserted here, the excessive use of judicial power. The courts, no less than the political branches of government, must respect the limits of their authority."

The Supreme Court has also decided that it will review the issue of whether the payments of "auditing" and "training" fees to the Church of Scientology for participation in church activities are deductible as charitable contributions under IRC 170. Conflicting decisions in the U.S. Courts of Appeals on this issue prompted the Church to file petitions for certiorari. The Supreme Court granted certiorari in two cases, Hernandez v. Commissioner, 819 F.2d 1212 (1st Cir. 1987), cert. granted April 18, 1988, and Graham v. Commissioner, 822 F.2d 844 (9th Cir. 1987), cert. granted May 23, 1988, and consolidated those cases. To date, the Second, Sixth and Eighth Circuits have disagreed with the Tax Court's decision to disallow such deductions while the First, Fourth, Ninth and Tenth Circuits have affirmed.

The issue of whether or not the Church of Scientology of California is entitled to tax exempt status under IRC 501(c)(3) will not, however, be heard by the Supreme Court. The Court rejected the organization's appeal of a Ninth Circuit ruling which upheld the Service's revocation of the organization's exemption. Revocation had been based on a finding that net earnings had inured to the organization's founder, L. Ron Hubbard. See Church of Scientology of California v. Commissioner, No. 87-1377; Church of Scientology of California v. Commissioner, 83 T.C. No. 25 (September 24, 1984); Church of Scientology of California v. Commissioner, 823 F.2d 1310 (9th Cir. 1987). In an additional Scientology case, an organization called the Church of Spiritual Technology filed a petition for declaratory judgment under IRC 7428 in Claims Court on October 6, 1988. The organization's application for IRC 501(c)(3) status was denied based, in part, on a finding of inurement to L. Ron Hubbard.

The Supreme Court also declined to review a case involving the taxation of the income of an official from the Basic Bible Church of America. The Eighth Circuit had found that the official was a principal, not an agent, of the Church and, therefore, subject to tax. See Page v. Commissioner, 823 F.2d 1263 (8th Cir. 1987) cert. denied January 25, 1988.

The Supreme Court also ordered the parties in Patterson v. McLean Credit Union, No. 87-107, to brief and argue whether the Court's interpretation of 42 U.S.C. Section 1981 in the landmark case, Runyon v. McCrary, 427 U.S. 160 (1976), bars racial discrimination by certain parties, including private schools, in deciding with whom they will contract or do business. If the Supreme Court modifies established law in this area, it could impact on the Service's treatment of churches that operate schools.

In the area of church schools, a case is pending in the Tax Court that may test the Service's position as set forth in Rev. Rul. 75-231, 1975-1 C.B. 158, and G.C.M. 39754 (September 8, 1988) that churches directly controlling or supervising a private school must demonstrate that the school is operating in a racially nondiscriminatory manner in order to obtain or maintain their exempt status. Second Baptist Church of Goldsboro v. Commissioner, Docket No. 23009-88 "X". Second Baptist Church of Goldsboro filed a petition for declaratory judgment on September 6, 1988, requesting that a determination that the Church was not entitled to exempt status because it did not show that the school it controlled was operated in a racially nondiscriminatory manner be declared incorrect and that, for the years 1983, 1984, and 1985, the Church be declared an organization entitled to exemption. Second Baptist Church of Goldsboro is the Church that assumed ownership and control over Goldsboro Christian Schools, Inc., one of the schools consolidated into the Bob Jones University case. See Bob Jones University v. United States, 461 U.S. 574 (1983).

In two lower court cases, claims of violations of Constitutional rights brought against the Service and Service employees by organizations that were denied exemption as religious organizations under IRC 501(c)(3) were dismissed by the courts. See Ecclesiastical Order of Ism of Am, et al. v. Joseph Chasin, et al., No. 86-2178 (6th Cir. April 18, 1988) and Church by Mail, Inc. v. United States, No. 87-0754-LFO (D.D.C. January 22, 1988).

There were also several lower court church rulings during the past year upholding the Service's denial of exempt status based on inurement or private benefit. These cases are as follows:

(1) Church of Modern Enlightenment v. Commissioner, T.C.M. 1988-312 (July 25, 1988).

(2) Good Friendship Temple, T.C.M. 1988-313 (July 25, 1988).

(3) Athenagoras I Christian Union of the World, Inc., T.C.M. 1988-196 (May 4, 1988).

The Service was also highly successful in several mail order ministry cases involving such issues as exempt status, deductibility of contributions, damages under IRC 6673 and summons enforcement. See, for example, Universal Church of Jesus Christ, Inc. v. Commissioner, T.C.M. 1988-65 (February 23, 1988), Mulvaney v. Commissioner, T.C.M. 1988-243 (May 31, 1988), and United States v. Universal Life Church, No. CV-F-87-118 (E.D. Cal. filed June 16, 1988).

Two recently decided cases involved sham churches and the conviction of taxpayers for tax evasion. See United States v. Washington, No. 87-00096 (M.D. Pa. October 29, 1987) and United States v. Jeffries, No. 87-2846 (7th Cir. August 11, 1988).

One ongoing church case that has generated enormous public interest is the Heritage Village Church and Missionary Fellowship, Inc., a/k/a PTL v. Commissioner, No. 250-88T (Ct. Cl. filed April 26, 1988) case. A petition for declaratory judgment under IRC 7428 has been filed by PTL and is presently pending with the Claims Court in connection with the Service's revocation of PTL's exempt status. The Service was able to revoke PTL's exempt status only after the Fourth Circuit upheld a district court's ruling dissolving a bankruptcy court's stay of the Service's revocation.

3. Legislative and Administrative Update

As discussed in last year's text, the Subcommittee on Oversight of the Committee on Ways and Means held hearings on October 6, 1987, to review the federal tax rules applicable to television ministries. The subcommittee continues to express its interest in this area. The Service is providing both a disclosable and non-disclosable report on its activities concerning television ministries to the Subcommittee each quarter. For guidance regarding the procedures for preparing the quarterly reports, refer to Manual Supplement 75G-47 (May 17, 1988).

In response to a request from the Honorable Charles B. Rangel, House of Representatives, for information on how the Service reviews tax law compliance on the part of churches and religious organizations, the General Accounting Office (GAO) issued a report entitled "Tax Administration: Tax Law Compliance of Churches and Tax-Exempt Religious Organizations" on August 11, 1988. GAO's study resulted in three basic conclusions. The study found that the Service monitors tax law compliance of tax-exempt religious organizations that are not churches in the same way it does for other charitable organizations. This conclusion is based on the fact that these religious organizations generally are required to apply for tax-exempt status and file annual information returns and the fact that between 1981 through 1987 between 2 and 3 percent of all exempt organizations that the Service examined were religious organizations that were not churches.

The report also concludes that the Service reviews churches' compliance with the tax laws much differently than it does for other tax-exempt religious organizations. The report notes that churches are excused from filing for tax-exempt status and filing annual information returns but must file tax returns if they have income in excess of $1,000 from sources substantially unrelated to their exempt purposes. The report also mentions the fact that special examination procedures are used by the Service when reviewing churches.

GAO's final conclusion is that the Service believes it has difficulty in assuring that churches comply with the tax laws because of the (1) lack of information the Service receives on churches; (2) specialized audit procedures required by law; and (3) complexity of issues common to all tax-exempt organizations, which can also affect churches.

The report noted that religious broadcasters may be viewed as religious organizations that are not churches, as churches, or both depending on how they have organized their operations.

The report only provided information. It did not make recommendations.

The Service has revised IRM 7(10)75 through 7(10)75.8 to refine procedures used by IRS agents in cases involving tax avoidance schemes by individuals using organizations that claim tax exempt status. See MT 7(10)00-145 (March 17, 1988). The courts continue to support the Service in their investigations of individuals who appear to take inflated charitable contributions deductions on their tax returns. The Second Circuit recently upheld an IRS summons for church records because

the investigation was directed against the individual, not the church. See St. German of Alaska Eastern Orthodox Catholic Church v. United States, No. 87-6053 (2nd Cir. February 24, 1988). The Court held that IRC 7611, which limits church tax inquiries and examinations, did not apply.

The Service has also revised IRM 7(10)71.74(3) to clearly state that, in church cases subject to the declaratory judgment procedures under IRC 7428, IRC 7611(g) provides that the agent's final report is treated as the final adverse determination under paragraph (1) of section 7428(a). Any church receiving such a report shall be treated for purposes of sections 7428 and 7430 as having exhausted the administrative remedies available to it and, thus, precluded from administrative appeal. The organization will not be sent a proposed adverse determination letter ("30 day letter") but rather will be sent only the final adverse determination letter ("90 day letter") with Form 4621, Report of Examination. See MT 7(10)00-149 (July 8, 1988).

The Service also amended Delegation Order No. 137 (Rev. 2), 1988-9 I.R.B. 5, effective April 13, 1987, in order to authorize District Directors to hold conferences described in IRC 7611(b)(3)(A)(iii) and to execute agreements under IRC 7611(c)(2)(c) to suspend the periods for completing church tax inquiries or examinations.

4. Conclusion

The Service's treatment of churches and religious organizations continued to be the subject of intense review by Congress and the courts in 1988. Whether this scrutiny will result in substantial changes to the tax laws applicable to churches remains unclear.